Are financial markets fit for purpose?

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Introduction

Financial markets exist only by the grace of savings. If individual households only earned an income, fully using this for basic consumption survival, there would be no loans, shares, bonds, options and futures, taking away the main elements of financial markets. The accumulation of savings has changed all this.

Financial markets play three main roles in the western world. They bring together buyers and sellers for equities, bonds and other tradable financial products. Their second main job is to list new equity and bond issues on these markets. Their third main role is to facilitate risk taking on currencies, interest rates and a whole range of commodities as well as on shares and bonds.

The trading activities, which take place on the stock exchanges, reflect the fact that some savers wish to acquire financial products, which other savers have bought before them. This reflects a savers substitution market. It is essentially the same as a market for fine art products, as the valuation is based on the eye of the beholder. The price set for financial products depends how many sellers are willing to part with their "art": their savings instruments, and how many others are interested to take over such savings products.

In their second role, financial markets are the key players in transferring savings to a government or to companies and through mortgage-backed securities to individual households.

Returning to the first role, stock markets deal with individuals' -and institutions on their behalf-, eager to trade. The price set is a trading price for those willing to sell and buy. Stock markets do not set prices for those, who want to keep hold of their portfolios of equities and bonds. A trading price reflects the transfer price of a financial title from one person or institution to another. A holding price should reflect the ability of the issuer of the collective of titles to redeem these titles over time. For instance, the collective of savers cannot all sell the outstanding U.S. government debt instantly, as the only buyer would be the U.S. government itself. For the U.S. government to do so, it would have to raise taxes to such an extent that the whole economy would come to a standstill. It would be an effort to switch a very long-term debt obligation into a very short-term repayment period. The economic need to hold onto the debt overrides the need to trade. Stock markets and in a wider context, financial markets do not produce a price for holding savings instruments. In their trading activities these markets cannot bridge the gap between the economic necessity to collectively hold on to the savings products for long periods of time and the market driven incentives to force immediate repayment of long-term obligations. Income levels of governments and of individual households cannot accommodate such forced repayment schedules.

The implications of the collective choices are the subject of this paper. Collective choices depend on the income earning capacities, be it those of a government, companies or individual households.

1. Financial markets and the allocation of savings

1.1 The allocation process

Individual households are the originators of all savings –the act of postponing consumption out of current income to some future date-. Individual households are also the owners of all savings: this represents their personal equity base. Individual households may decide themselves how to invest their savings, but more often than not they leave it to companies or institutions which have been set up to arrange for such funds to be invested. Such institutions are banks, pension funds, life insurance companies, hedge funds, private equity funds and some other savings vehicles. Stock markets have been set up to trade in financial products. The savings levels, which are traded on such markets, represent a very substantial share of the total savings in western societies.

Individual households plus all their representative organizations in the financial markets decide how funds are to be allocated to the three main user groups: a government, companies and individual households acting as borrowers.

The process of the allocation of savings is often a complicated process with many intermediaries involved. A simple example may make this clear. Banks usually obtain a substantial share of their funding from their own client base, which may be individual households, companies, some government entities or charities. If companies deposit money, it already reflects an indirect ownership of the savings for the individual households. Banks may use the entrusted funds to lend to their own client base, like for home mortgages and consumer loans; they may lend working capital to companies or they may buy companies' or government bonds. In case of excess funds, they may lend funds to other banks, including to those in other countries. The own equity of an individual household is spread over many different uses. This process is further complicated by savings allocated to pension funds, life insurance companies, hedge funds or other institutions which represent individual households. The links between the originator of savings: the individual household and the ultimate users of the savings may follow a nearly untraceable path. One U.S. dollar in savings may be split up and end up in many different savings allocations and locations.

1.2 The intermediaries in the savings allocation process

In the above section it was already made clear that there are many intermediaries in the savings process to guide savings to their ultimate destinations. Such intermediaries could be classified as: "facilitators". They are not the ultimate users of savings. The latter are a government, companies and individual households acting as borrowers.

Recently, Mr. Haldane, the Bank of England's executive director for financial stability, expressed the view that the massive fund management industry could potentially pose a systemic risk to the global financial system.

According to Mr. Haldane the global asset management industry controls $87trillion of funds under management. This roughly equals the world's economic output in 2013. Like in most other businesses, the top 20% of the asset management companies control roughly 80% of the assets under management. The largest asset management company Blackrock is now 25% larger than the largest bank in the world: the International and Commercial Bank of China.

There are at least three aspects to this concentration of power, which have an impact on the savings allocations made on behalf of individual households.

The first aspect is related to the reduced number of decision makers. The second aspect reflects the use of technology and the third aspect is linked to regulatory actions.

In having savings concentrated in asset management organizations, including in pension funds, the choices how to allocate savings are no longer made by the millions and millions of individual households, but by a few thousand asset management companies and pension funds. This severe reduction in the number of decision-making participants has a number of advantages, but also strong disadvantages.

To start with the advantages: the main one relates to economies of scale. Asset management companies can build up their expertise to a level, which very few individual households can match. A larger size should mean lower operating costs and a much wider sector as well as geographical spread of individual financial assets; something, which most individual households are unable to achieve.

However the shift from an individual households' choice to an institutional one has also negative implications. The lack of full market knowledge and the relatively higher costs related to dealing in smaller sums of savings keep many small investors holding on to their share and bond portfolios, rather than becoming frequent traders. In the next section it will be explained that holding on to share and bond portfolios may not only be beneficial to an individual household, it is also an economic necessity. Just as an example, financial markets do not assess a "price" for holding, but only for selling and buying, irrespective of the time period required by the borrower to repay debt or equity – the latter through dividends or repurchase of shares-. Most western governments need seventy or more years to repay their debt. A single day's price of a government bond does not reflect its maturity level of up to seventy years. Collectively savers cannot sell these debts back to the issuer; as such action would imply collective economic suicide.

The savings allocation choice of empowering institutions as the go-between has a strong in-built bias in favor of the short term. The first reason is the competition for new savings, including moving savings from one institution to another. "Assets under management" levels have all kind of benefits for the employees working in a particular asset management company, pension fund,

life insurance company or hedge fund. One relates to costs per unit of savings and the second one to bonuses per employee.

Competition in the savings management business is often based on relative performance levels. To outshine competitors, performance of a fund is compared to the performance of other funds in the same asset class: the relative performance. For the individual household it may still mean an actual loss on their savings level, but the relatively better performing funds claim to be better in their job than competitors. Underperforming funds are often closed or merged with other funds: a clever way to remove poor performances.

Another element of institutional management is the shift over the last decade away from actively managed funds in large cap equities and government fixed-income markets. About a decade ago two-thirds of funds under management were actively managed, according to Mr. Haldane, while currently about only half of the assets under management are. This shift creates more followers rather than leaders in the markets. It also leads to a quick turnover, when prices change. Exchange traded funds reinvigorate this trend as do all the derivatives, which make betting on price developments of financial instruments possible.

Over the last 50 years a main trend line stands out. The importance of individual holdings in shares and bonds has been strongly reduced and has been replaced by institutions acting on behalf, but without their consent in many cases, of individual households. The other trend is the shift away from active to passive management of portfolios. Both trends have reinforced the short term trading bias, which currently exists. Trading rather than holding has become the norm.

The second aspect reflects the use of technology in dealing in shares and bonds. The quick-fire trading firms can buy and sell shares in milliseconds. According to the U.K. Sunday Times of 6th April 2014, high-frequency traders now conduct about two-thirds of the trading on US exchanges and one-third of trading on the London Stock Exchange. Their systems chase market trends, then buy stocks and sell them again before ordinary investors have a chance to react. Technology developments have reinforced the trend towards trading rather than holding; towards the very short term rather than the long term.

The third aspect involves the regulators. By setting the standard at the daily trading price rather than the long term holding price, regulators themselves have moved the goal posts towards the very short term. In previous articles it was explained that holding rather than trading should be encouraged, especially for pension funds and life insurance companies, which have long-term investment objectives to suit their client base. The distinction made between economic savings -savings which contribute to output and employment growth- and financial savings -the ones that do not do so-, helps to assess why holding on to portfolios is so essential for promoting economic growth.

1.3 The economic and financial use of savings

Individual households earn an income and they use part of this income for consumption expenditure. The purchasing power of such expenditure remains the same from one year to the next if consumer prices do not change. In a period when the CPI inflation level rises faster than the average income of individual households in an economy, it is widely accepted that the value of the income flow is depreciated against the values of the prices on offer in an economy. Such depreciation occurs both to the internal value of a currency and to the purchasing power as expressed in foreign currency terms. Individual households lose the ability to buy the same package of goods and services as in previous years. The loss is particularly painful for those on low-income levels, including the young and the unemployed as well as those households who have no savings. The depreciation of the values of incomes can be called the income depreciation factor.

The same depreciation effects apply to savings. Savings can also lose their purchasing power through events linked to the price developments in homes, shares and bonds and the volume effects of increased government debt. It specifically applies to:

- The increase in house prices over and above the CPI inflation level, provided those incomes do keep up with the CPI inflation level;

- The increase in share and bond prices after the initial transfer of funds when companies list their shares and bonds or governments' their fixed-rate bonds on the stock markets;

- The increase in government debt outstanding after a year, if the use of government funds does not create its own cash flow, but has to be recovered from the individual households' future income levels.

All these three factors can cause the savings depreciation factor.

A saving of one dollar, Euro or pound sterling may appear in statistics as an identical unit of each currency over time. However, the key point of the savings depreciation factor is to indicate that the purchasing power of such unit saved may change when house prices rise faster than savings out of incomes or when share or bond prices change after the issue date or when a government increases its claim on future individual households' income and savings levels by increasing its government debt levels.

Take house price rises. Most individual households are unable to provide all the needed equity to acquire their own home. They use outside savings –other individual households' savings- as outside equity to fund their home purchases. The outside equity component can have two different effects: a volume effect when more homes are built and a price effect when house prices rise above the rise in average income levels in a country. The volume effect of new house building creates jobs and output: savings were allocated to promote economic

growth and employment. In a previous paper this type of savings allocation was called: economic savings. The price effect of outside equity occurs when house prices increase faster than the CPI level provided that incomes develop in line with the CPI changes. Savings are not being used for the construction of more homes, but to help inflate house prices over the CPI level. This use of savings was called: a financial use of savings. Such use of savings does not contribute to output growth and employment creation; it can also be called the un-economic use of savings.

The purchasing power of a unit of savings depends on whether this unit was applied as an economic saving or as a financial one. The savings depreciation factor measures the extent to which the purchasing power of a unit of savings is reduced as a consequence of a shift in allocation between the economic use of savings and the financial ones.

The fact, that in the U.S. in 2005 and 2006 65.5% of all money made available as home mortgages in these years ended up in funding house price increases over the CPI level, showed that a disproportionate savings allocation was made to financial savings rather than to an economic use. The second fact was that a substantial share of such new mortgages was incorporated in mortgage-backed securities, which were sold mainly to U.S. and European institutions. The third fact was that over 90% of the so-called sub-prime mortgages were granted on a variable interest rate basis after the two-year start-up fixed rates. The combination of excessive lending practices, increased base rates, low individual households' own equity levels and market securitization of a product that under the excessive lending conditions should not have been pushed into securitization so strongly, all led to the severe financial crisis of 2008.

2. Policy instruments and their relationship with economic or financial savings.

2.1 Introduction

Savings from the category economic savings finance economic growth and a higher degree of employment. Such savings help create the volume increase in output and in employment levels. Financial savings are savings that cause price changes in homes in excess of average income growth; the same financial savings cause changes in shares and bonds prices after their listings. An increase in government debt levels cause future incomes and savings to be worth less in purchasing power. Different policy measures are needed depending on whether the savings were used in an economic manner or in a financial one. While both categories of savings originate from the same incomes of individual households, their effects on the economic situation in a country are totally different. The economic impact of each dollar, euro or pound sterling saved, depends on it allocation, its use, in society.

The income side of individual households is mainly and often practically exclusively determined in the workplace. The level of unemployment is

determined by the collective decisions of companies and a government. Collective bargaining exists in many workplaces. The outcome of such bargaining determines the incremental values of the wage or salary increase. Self-employed individuals may accept lower incomes, in the hope of an increased income in the future.

The income side of individual households and thereby the savings side depends on the level of economic activity in a country, the scarcity of employees in some professions and the change in consumer prices.

Some groups like the low earning individual households, the young, the unemployed and those without any savings do not benefit from the existence of financial markets. These groups are totally reliable on income earnings only. They do not participate in any way in the increased values of property, shares and bonds or other elements of these markets. Whatever happens in the financial markets may not benefit them, but it can harm them when savings are used for an excessive financial use of savings for home acquisitions and shares. It also harms them when a government is forced to increase its deficit funding as a consequence of the misallocation of savings to a financial use for both homes and shares. Any increase in indirect taxation harms the low-income groups more than the wealthier ones.

For all these situations it is generally accepted that prevention works better than a cure.

2.2 An analysis of the benign neglect of the individual households' equity crisis

In a previous paper called: "The benign neglect of the individual households' equity crisis"[1], it was argued that the financial crisis was not created in a single year, but was brought about by years of neglect of the savings levels out of individual household's incomes allocated to the down payments –own equity- for buying one's own home. In the U.S. in every year from 1997 to 2006 house prices increased above the CPI inflation levels, while the median income level of individual households moved up slightly below the CPI level. The pace of such increase in house prices accelerated from 2002, widening the gap what the savings out of median incomes could afford and the down payment needed for inflated house prices. The paper calculated that in 2005 and 2006 from the total volume of new home mortgages 65.5% was allocated to a price increase for homes and only 34.5% was used for the construction of new homes. The economic use of savings had dropped to 34.5% of the outside savings allocated to buying homes in the U.S. over these two years.

The median income level needed to maintain the same purchasing power of a dollar of savings over the period 2000-2006 for buying a home in the U.S. would have been $63,246 in 2006, while the actual median income level was $47,262. Therefore the savings depreciation factor over the period 2000-2006 was 33.8%.

[1] http://mpra.ub.uni-muenchen.de/53273/

In this example, the savings depreciation factor measures the change in purchasing power of $1 in savings used for acquiring a home for one's own use over the period 2000-2006. Income developments lagged behind the price developments of homes. The financial use of savings –causing house prices to rise faster than income developments- did not lead to extra homes being built. It did not create output or additional jobs; hence the term "financial use of savings" or "un-economic use of savings".

In January 2006 the number of housing starts on an annualized basis in the U.S. reached its peak of 2.12 million homes. For construction companies building new homes is more attractive at rising prices. However for individual households when house prices rise faster than their savings values –measured with the help of the savings depreciation factor- the reverse is the case. Savings allocated to price rises over the CPI index; provided that median incomes keep pace with the CPI index, harm the ability of individual households to continue buying homes. It shuts large groups of individual households out of owning their homes.

In 2008 in the U.S., some 53 million households needed a mortgage among some 80 million homeowners. Only the very wealthy and the older generation can usually afford to live in a mortgage free home.

Income developments and the savings level out of incomes determine the capacity of individual households to acquire a home. The financial use of savings artificially inflates the price level of homes, putting the acquisition of a home beyond the reach of many households. Outside equity –borrowed funds- used for inflating home price rises above the CPI level reduce the value of own equity –an individual household's own savings. The value of an outside equity dollar starts exceeding and thereby deviating from the value of an own equity dollar. A dollar saved and allocated as outside equity, is no longer equal to a dollar saved by individual households from their own income for getting onto the property ladder. The savings depreciation factor measures this phenomenon.

The un-economic use of savings –financial savings- forces out the economic use. The implications of this statement are substantial. Crowding out in the home ownership markets has many consequences. Firstly it diminishes the chances for lower paid workers –those below and up to and including the median income level- to buy their own home. The housing market becomes a market for the richer classes only. Secondly financial savings do not lead to more output and employment growth; such allocation of savings only inflates asset prices above the CPI inflation levels, without contributing to the valuable parts of economic growth. Thirdly the seeds for an economic recession are contained in this un-economic use of savings.

In the U.S. example, the policies applied did not focus on the providers of outside equity –the commercial and investment banks as the facilitators of the un-economic use of savings-, but on the buyers: the individual households. Base interest rates were increased from 1% in June 2004 to 5.25% in July 2006. For individual households that already had a variable rate mortgage, this increase reduced the opportunities to save more for building up own equity levels. The

un-economic use of savings was promoted over its economic use. Rather than acting as a correction factor, the base interest rate increases led to a widening of the gap between un-economic uses of savings to the detriment of the economic ones.

In the U.S, during the years 2004-2007 the collective of banks increased their mortgage lending to the extent that in 2005 and 2006 65.5% of all new annual lending went into house price rises over the CPI inflation index. The banks also singled out the lower income groups as potential borrowers and enticed them with a mortgage product consisting of a low 2 year start up interest rate with a variable rate thereafter, not to mention self-certification of incomes combined in many cases with no down-payments either. Banks also offloaded slightly more than $5trillion of the $10trillion U.S. national home mortgage portfolio via the financial markets to other outside equity providers, including a substantial share to European savers groups. Mortgage backed securities were organized and sold worldwide.

The financial authorities in the U.S. did not execute policies to slow down the un-economic use of savings organized by the financial institutions; they also did not slow down the distribution practice of such un-economic savings around the world. This lack of policies did in effect widen the gap between the use of un-economic savings and the growth of economic ones. The financial market participants were initially let off the hook. However when a large number of individual households could no longer afford to pay for their home mortgages, the markets for mortgage-backed securities collapsed. On August 9, 2007 BNP Paribas suspended three investment funds in mortgage-backed securities as a complete evaporation of liquidity had occurred. The losses for outside equity holders started to accumulate and the process to bring the value of an outside equity dollar back to an own equity one had started.

The collapse of the un-economic use of savings drove outside equity providers to make their claims against own equity holders. The ultimate results were that 5.4 million U.S. households lost their homes over the period 2008-2012 due to repossessions. Over the period 2004-2012 21.4 million households were put under extreme financial pressure as foreclosure proceedings were started against them. The consequences were that over the period 2006-2011 house prices dropped by 28.9% in value and by $6.6 trillion in actual amounts. Over the period 2007-2013 8.714 million fewer homes were built as compared to the 2005 level of new housing starts. Own equity holders also reduced the net total outstanding mortgage amount over the period 2008-2013 by over $1.2 trillion, so that the owners' equity as a percentage of household real estate moved up from a low of 38.4% in 2009 to 51.7% by the end of 2013.[2] Such repayment of the national mortgage portfolio is an unusual but also an unwanted phenomenon. It happened at a time that the U.S population was growing. The

[2] http://www.federalreserve.gov/releases/z1/current/accessible/b100.htm

individual households did what the authorities could have prevented them to do, not directly, but indirectly. If the focus of the authorities would have been on what the financial sector –the banks, investment banks and insurance companies- did altogether, namely using savings in an un-economic manner and if the authorities had used their powers to prevent this happening, than individual households would have had no reason to use their reduced incomes to repay a substantial share of their national home mortgage portfolio. Economic growth would have continued, government deficits would have been substantially smaller and companies would have seen their demand levels drop much less.

Under the prevailing circumstances the U.S. banking sector itself was affected as it was still holding about half of all mortgages. Some investment banks had a very high gearing ratio and Lehman Brothers went bankrupt in 2008. Fannie Mae and Freddy Mac had to be rescued as well as AIG Holdings. Other banks were provided with lifelines. In other countries governments also rescued banks. There was one group that did not get support: the individual households, especially those up to the median income level.

2.3 The financial markets and the un-economic use of savings

Financial markets are unequal to any markets for goods and services. Financial markets do only exist by the grace of savings. The U.S has collected data over many years, for instance by assessing the Balance Sheet of Households and Nonprofit Organizations. From these data one can deduce that over the last fifty years (1963-2013), the total assets of households in nominal terms have multiplied by nearly 35 times. Over the same period the non-financial assets have multiplied by 32.7 times and the financial assets by 35.9 times. Over the last fifty years, the most dramatic shift in the distribution between non-financial assets and financial assets took place over the period 2003 to 2013. In 2003 the non-financial assets stood at 37.17% as a proportion of total assets, while the financial assets reached 62.83% by the end of the same year. By the end of 2013 these data were completely different. Financial assets had grown to 70.9% as a percentage of total assets, the highest-level recorded in 50 years and the non-financial assets were only 29.1%.

In 2005 and 2006 U.S. banks had collectively applied 65.5% of their level of savings used for mortgage lending, to enhance house price rises over and above the CPI level. This un-economic use of savings undermined the purchasing power of individual households' savings out of incomes to get onto the property ladder. Simultaneously banks offloaded slightly more than $5trillion to other domestic and international savings providers, freeing the banks from holding capital against their home mortgage portfolios for about half the U.S. national home mortgage portfolio.

At the end of 2013 the collective U.S. individual households' holdings of financial assets were $66.95 trillion and the U.S national home mortgage portfolio just $9.37 trillion. It was not the supply of savings that caused the problems; the

economic and financial problems in the period 1997-2007 were caused by an un-economic use of savings during these years to inflate house prices over and above the CPI inflation level. Over this period more and more low and middle income families were forced out of the housing market as their income and savings growth could not keep up with the rising house price levels. It led to a severe financial stress for many of those individual households who had entered the mortgage markets. Nearly 43% of all U.S. mortgagees or 21.4 million households were involved in foreclosure proceedings during the period 2004-2012 and 5.4 million homeowners had their homes repossessed and lost all their own equity.

The errors made by the collective banking and financial sectors in pushing up house prices up above the CPI level by using a savings allocation that did not produce output and employment growth, led to the individual households' income and savings crisis. The first element was the reduced value of savings as expressed through the savings depreciation factor, for the use as own equity to purchase a home. The second element was the pressure on incomes for all mortgagees caused by increases in variable interest rates, when base rates were increased from June 2004 to July 2006. The third element was the great effort made to satisfy outside equity providers at the costs of own equity ones. This together with the costs for the increased interest rates pushed many households near the edge or even over the edge. The repossessions forced house prices lower reducing the purchasing power of own equity further. Income levels came under strain and as a consequence demand for goods and services suffered and unemployment rates went up, undermining the savings levels for own equity even further. Banks came under strain as their own mortgage portfolios also came under stress. Shares of banks and many other companies dropped severely in 2008. The government had to step in and over the period 2008-2013 it was forced into a steep increase in its government debt level. The latter reduced the chances for building own equity further as future incomes will be reduced through this increased level of debt.

The process of building up own savings by individual households were crowded out and hampered through the misallocation of savings by the banks. The un-economic use of savings by the financial sector shows that the actions of the financial sector can harm economic growth, income growth of individual households, the level of job opportunities in the U.S. and in other countries and the potential level of savings needed to buy homes.

2.4 The U.S. and the U.K.s governments' response

What both the U.S. and the U.K. governments did not do in 2005 and 2006 was to stop the allocation of savings to an un-economic use of such savings. This could have been done in the U.S. by installing a traffic light system whereby lenders would have been warned that if the volume of home mortgage lending would

lead to substantial house price rises over the CPI level, they would have to pay substantial fines. This was not done. The U.S. and U.K. governments could also have imposed substantial fines on the investment banks for facilitating banks to circumvent the capital equity ratios of commercial banks by selling mortgage-backed securities to the markets. Again this is a volume control measure, rather than a prohibition to engage in such practices. Both the U.K. and the U.S. governments did not practice such control measures.

What the U.S Federal Reserve and the Bank of England did was to engage in quantitative easing. This was done in buying up government bonds or gilts in the U.K. as well mortgage bonds, especially in the U.S. case. In the U.K. the Bank of England bought up £325 billion in gilts. In the U.S. the Fed had as of 23 April 2014 slightly over $4 trillion in securities of which $1.634 trillion in mortgage backed securities and the remainder in government bonds. Quantitative easing is a policy instrument based on an injection of savings by buying up bonds, gilts and mortgage bonds, the latter especially in the U.S. What the governments around the world did not consider is that economic growth can only be based on the growth of individual households' incomes. The Fed and the Bank of England were not the most logical choice of institutions to solve the pressure on incomes of individual households.

What the central banks did was to expand the level of savings by injecting more savings into the financial markets. The financial markets did not need more savings, but they needed a redirection of savings from a non-economic use to an economic one. The latter would be most effectively achieved by the proposed "economic easing" exercise as described in the paper "The benign neglect of the individual households' equity crisis". Such exercise helps all households, but by applying an equal sum to all households, it helps especially the young, the unemployed and the below median income earning households more than the more wealthy ones.

2.5 The threat of deflation

Many European countries are entering an era of low inflation or even deflation. Deflation is often linked to a lack of macro-economic demand for goods and services in a society. Economic savings create demand and un-economic ones like financial savings do not.

The threat of deflation can be tackled if a consensus exists that there are more than enough savings floating around in the financial world, including the additions as made by the Central banks. The crux of the matter is to get such un-economic savings turned into economic savings and make them available to countries where the allocation of savings process has gone wrong. Southern European countries come to mind, but also some northern European ones like The Netherlands and Sweden. In the Southern European countries demand levels have been so weak that many young and a large number of other individuals are unable to find jobs.

In the paper: " The benign neglect of the individual households' equity crisis" it was suggested to transform some funds accumulated in pension funds for a national "economic easing" solution. The Netherlands and Sweden may be cases in point. For most Southern European countries within the Eurozone, it could be a task for the European Central Bank. The latter could borrow Euros in the financial markets and transfer such funds to individual households in the Southern European countries via their national central banks. Funds could be distributed with an equal amount paid per individual household, which helps the young, the unemployed and the lower wage earners more than the better off. However the formers' propensity to spend the extra incomes on goods and services is much higher than for the richer classes. If governments agree to have such amounts to be transferred free of tax, than the impact is multiplied.

Deflation can be counteracted by economic easing exercises. Such exercises will most likely only be needed for two or three years in order to get economies back to their long-term growth path.

3 Conclusions

3.1 Differences between the company sectors and the financial sector

Savings used in the company sector are usually incorporated in the production process, creating products or services that need to be sold. The key difference between the company sectors and the financial one is that the company sectors are the ultimate users of savings, while the financial sector acts as the savings allocation organizers. In a company, a product or service incorporates the costs of the savings used, either as costs for equity, loans or bonds. The product or service combines raw material costs, the intermediate product costs, plus the costs of labor and of the funding attracted from the financial sector. For corporate businesses not incorporated, but privately owned the equity funding is usually provided by the company owners. The price set for a company's product or service is based on these supply costs as well as on the demand levels exercised by the buyers. A final product or service delivered to consumers includes the costs of savings allocated to the respective company.

During the last recession and slow growth period many large and multinational companies started to hoard funds, rather than using such funds in the production process. In this manner they, for this part, became part of the financial sector, as such savings were re-allocated back to the financial sector. The main cause was that expected demand levels were too low to start investing in any supplies that companies use to expand production.

The financial sector acts as the distributor of the savings entrusted to it. It does not itself produce products or services that can be used for immediate consumption. Its products represent indirect funding mechanisms for the ultimate users of such savings: the companies sector, a government or individual households acting as borrowers. The key difference with the company sectors is that such savings are allocated on basis of expected future income levels of others, namely companies, individual households and a government. Another

key difference is that companies cannot use savings to create a rise in their assets' values. Only a rise in sales levels will help to improve profitability. The collective of banks can lend so fast that asset prices of homes can exceed the CPI inflation index. The actions of all banks together, through their savings allocation process, can change the values of homes faster than individual households' income and savings levels. The savings depreciation factor sets in.

3.2 Competition in the financial sector

It is often claimed that more competition between banks would lead to a better service and lower costs to the consumer, especially the individual households. It is also claimed that some banks have become "too big to fail".

The competition argument fails to impress as the experiences from the most recent economic recession have shown. U.S. banks were competing fiercely during 2005 and 2006 to get as many mortgages on their books as possible and subsequently offloaded such mortgages as quickly as possible to outside savers through the issue of mortgage-backed securities. As indicated in the main text of this article the collective actions of the banks made the difference, not which bank competed with which other in the home mortgage lending process. Collectively the U.S. banking sector allocated savings not only to increase the volume of new homes built, but also to fund house price rises far above the CPI inflation index. The mortgage securitization process made it possible to transfer the risks on the loans to other banks and to non-bank savers.

Companies are punished through the markets for their specific product or service on which they cannot earn enough to make a profit for their output sold. Mortgage lending volumes are not regulated through market behavior in the same manner. Banks do not stop lending when house prices rise faster than the CPI index. Competition forces them to go on. The fact that such lending depreciates the value of savings out of median incomes for those trying to get onto the property ladder did not affect their action plans. Many households were not their customers. Asset values rather than savings abilities of those who are not the banks' clients, influenced their actions. The fact that the use, the allocation of savings, causes house prices to rise faster than the CPI levels, was never considered a deterrent to continue lending. Collective the banking sector rather than any particular bank caused the individual households' equity crisis. The supply of savings was mainly used for an un-economic use application, something companies would never do or would even be able to afford to do.

The bank supervisors or other authorities did not deal with this weakness in the banking competition structure. The Bank of England's current implementation of new banking rules for granting mortgages should be welcomed, but it comes after house price rises in the U.K. have far exceeded median incomes' growth levels. There is always the danger that the rules would not be revised down, once in place and once the income situation for individual households has caught up with house price rises.

3.3 The macro economic implications

Prevention is better than a cure.

What the authorities could have done, but did not do, was to slow down the mortgage volume growth as soon as house prices started to exceed the CPI inflation index. What the authorities also could have done and did not do was to slow down the mortgage securitization process for exactly the same reason.

What quantitative easing did not do is to improve the individual household's income and savings depreciation levels. What it did do was to create more savings in society rather than arranging of a transfer from the financial and un-economic use of savings to their economic use. How the latter process could work has been described as economic easing and has been set out in a paper: "The benign neglect of the individual households' equity crisis".

When financial markets cannot self-regulate themselves, they need supervision. As it stands, financial markets have a strong short-term bias and governments would do well to take this bias away, for instance by issuing all their bonds as index-linked bonds. Financial markets do many good things, but they are equally able to destroy economic growth, income earning job opportunities, individual households' savings levels and ultimately themselves. They, more than the company sectors, need to macro-economically being managed. There are opportunities to do so if the authorities recognize that an economic situation can arise in which a gap is created between the values of outside savings and own savings. This happens when house prices are induced to rise faster than the CPI level through the wrong un-economic allocation of savin

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